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# US Life Insurers' Marginal Increase in Investment Risk Won't Hurt Portfolio Credit Quality

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*This article is an extract from a special comment published on www.moodys.com in May 2017. It is reprinted here with permission.*

## SUMMARY

Although they've risen recently, interest rates in the US remain low, and US life insurers' investment yields will continue to fall this year as insurers reinvest proceeds from maturing bonds into new, lower-yielding securities. Over the past several years, US life insurers have gradually been increasing investment risk in their portfolios to generate higher returns, according to Moody's review of insurers' investment portfolios. However, in Moody's opinion, the increase in risk has been marginal, and the credit quality of the industry's investment portfolio remains stable.

## BELOW ARE KEY TAKEAWAYS FROM OUR ANALYSIS:

» **US life insurers have not materially changed their portfolios' overall investment risk.** Insurers continue to hold broadly diversified and conservative investment portfolios comprised mostly of high-quality fixed income investments. Credit quality in the portfolios remains steady, and the industry should be in a solid position when the long credit cycle finally turns, at which point investment losses will increase to more historic levels. Exposure to energy investments remains a challenge, and could introduce more investment losses, especially if oil prices decline. Many energy company bonds have already fallen below investment grade, or may do so, given the difficulties in that sector.

» **Allocations to less-liquid securities on the rise.** Life insurers have been increasing their investments in private bonds and commercial mortgage loans, giving up liquidity to gain additional yield at the margin. Within commercial real estate, exposure to the retail sector, particularly mid and lower-end Class B and Class C properties, could increase the risk of losses for insurers.

» **Exposure to alternative investments declines modestly.** US life insurers' allocations to alternative investments, notably hedge funds, have dropped slightly, and the aggregate allocation for the industry is now near year-end 2013 levels. Recent announcements indicate that insurers will likely further pare back investments in hedge funds over the next several years, although some of this will be reinvested back into different alternative investments, such as private equity.

## LIFE INSURERS' PORTFOLIOS REMAIN BROADLY CONSERVATIVE

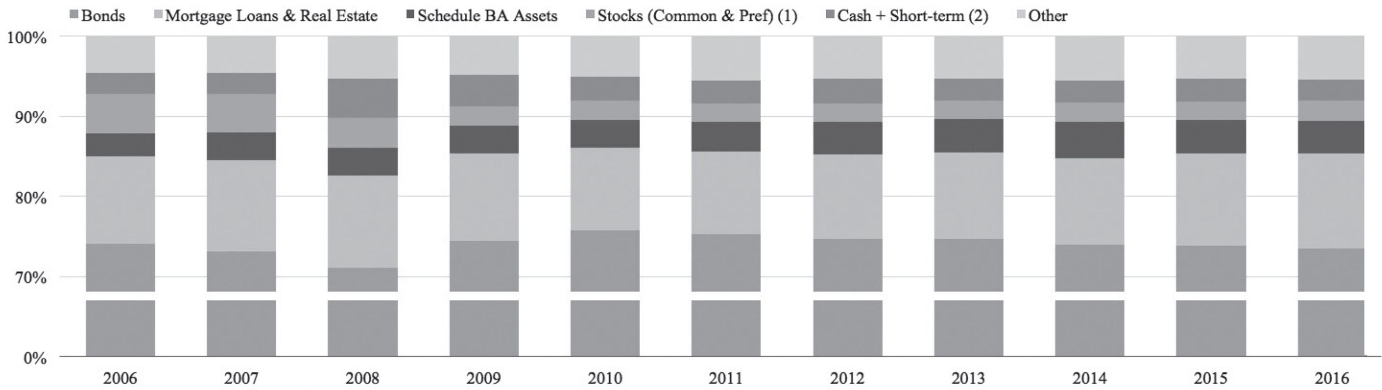
The historically low interest rate environment has led life insurance companies to reach for yield by modestly adding risk to their investment portfolios to ensure their investment income will cover their long-term liabilities. In Moody's view, the shifts in investment allocations to offset the decline in portfolio yields are not a credit concern at this point, because they are within historical norms and consistent with our expectations.

The 10-year US Treasury bond yield began 2016 at 2.2%, declined by mid-year to below 1.5%, then reversed course to end the year at 2.45%. Thus far in 2017, 10-year Treasury rates have been flat, ending Q1 2017 at 2.4%. In March 2017, the Federal Reserve increased short-term rates by 25bps, and has indicated there will be additional increases later in the year.

Corporate spreads are another important component of life insurers' investment returns. After peaking in Q1 2016, corporate spreads have tightened in 2016 and into 2017, pushing down reinvestment rates even further. Most life insurers have relatively long-duration portfolios, and the impact of lower reinvestment rates is felt over time, since their portfolios turn over at a rate of around 10%-15% per annum. Life insurance industry portfolio yields have continued to decline, to 4.55% in 2016 from 4.66% in 2015 and 4.83% in 2014.

The US life insurance industry's total net admitted cash and invested assets increased 5.1% to $3.9 trillion at year-end 2016 from $3.7 trillion at year-end 2015. As shown in Exhibit 1, US life insurers' portfolios remain relatively conservatively invested, with nearly three quarters of cash and invested assets invested in fixed income bonds – the vast majority of which are investment grade – for the past several years. The next largest category, which includes mortgage loans and real estate, has been gradually expanding, reaching 11.9% of cash and invested assets at year-end 2016, up from 10.8% at year-end 2013. After gradually rising for several years, Schedule BA assets – a range of alternatives assets, such as private equity and hedge funds – declined modestly over the past 18 months and represented 4.1% of cash and invested assets as of year-end 2016. Cash and short-term investments declined slightly in the second half of 2016, returning

Exhibit 1
US Life Insurance Industry General Account Asset Mix as % of Cash & Invested Assets




(1) Includes investments in affiliates
(2) Includes net admitted contract loans, premium notes and derivatives
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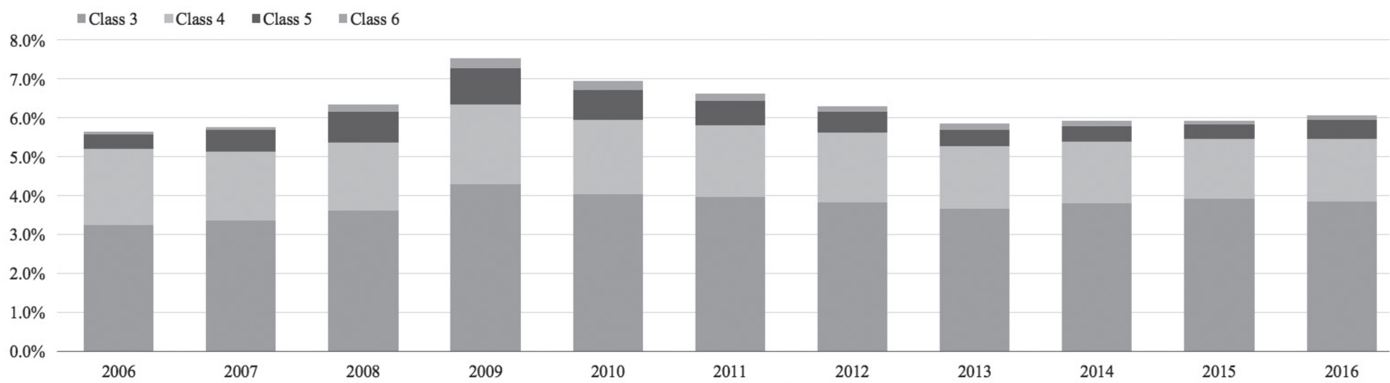
Exhibit 2
Below Investment Grade Exposures Have Stabilized
NAIC SVO Investment Class Designation as % of Total Bonds

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to pre-financial crisis levels, ending 2016 at approximately 2.6% of cash and invested assets.

## CREDIT QUALITY REMAINS STEADY, LEAVING THE INDUSTRY PREPARED FOR A FUTURE DOWNTURN IN THE CREDIT CYCLE

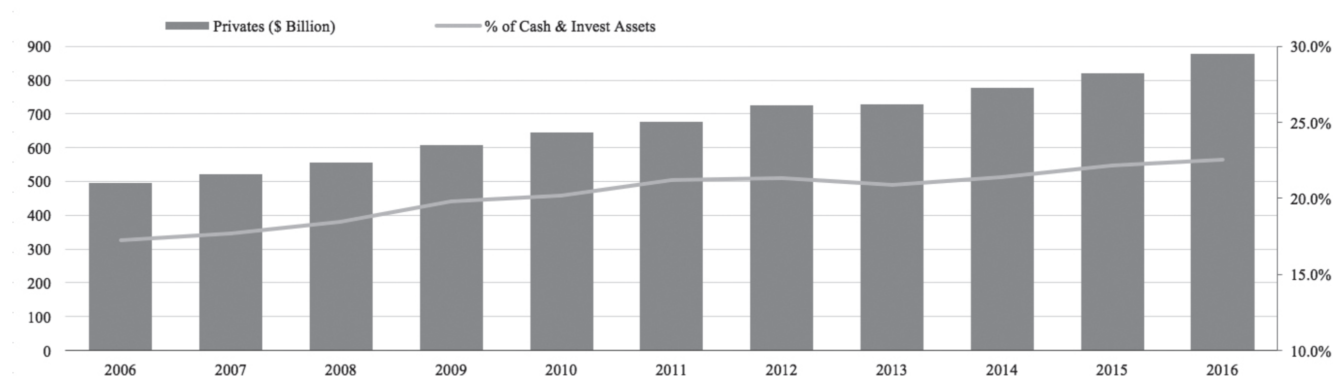
From a credit perspective, US life insurers have not been increasing their exposures to below investment grade (BIG) securities. As shown in Exhibit 2 below, BIG holdings have remained relatively steady at approximately 6.0% of total bonds for the past three years.

The Moody's US speculative grade default rate is expected to decrease to 3.0% in 2017, down from 5.7% at year-end 2016; however in the pessimistic case, this would increase to about 9.0% by year-end 2017. Nonetheless, with the US economy at full employment, the current expansion is likely entering its later stages.

## ENERGY INVESTMENTS REMAIN A CHALLENGE, BUT INDUSTRY APPEARS WELL POSITIONED

Insurers' investment balances in below investment grade holdings at year-end 2016 are likely to rise as a result of fallen angels in challenged sectors. A significant number of energy sector holdings have experienced negative rating actions in 2016, lead-

Exhibit 3
Holdings of Private Securities Increasing Again
US Life Insurance Industry's Private Securities Holdings as % of Cash and Invested Assets

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ing many to fall below investment grade. Energy holdings are a common investment universe for life insurers and have typically represented about 6%-8% of fixed income investments. For the US life insurers' energy-related investment holdings, we expect continuing unrealized losses and modest impairments in 2017. Although Moody's does not expect energy prices to fall, lower energy prices would reduce the returns of these portfolio holdings. A number of insurers have already taken write-downs on their more troubled energy holdings, somewhat mitigating the impact of a downside scenario in energy. Additionally, some insurers took advantage of the rise in energy prices in 2016 to trim their energy-related investment holdings.

## LIFE INSURANCE INVESTMENT MIX SHIFTS TOWARDS LESS LIQUID INVESTMENTS

Life insurers are increasingly sourcing private placements and commercial mortgage loans (CMLs), which are both less-liquid asset classes, to improve investment returns. With the increased focus on higher-yielding asset classes, insurers will need to carefully balance the benefits of increased yield with the impact of greater risk and/or less liquidity in their investment portfolios. Additionally, as markets become more competitive, insurers will need to balance credit risk with their search for additional yield.

During the past several years, US life insurers' allocations to private bonds have continued to increase as the companies trade liquidity for additional yield. As shown in Exhibit 3 below, the US life insurance sector's investment allocation to private bonds increased to $878 billion, representing 22.5% of cash and invested assets at year-end 2016, up from 20.9% as of year-end 2013.

## COMMERCIAL MORTGAGE LOAN HOLDINGS HIGHER, BUT WELL DIVERSIFIED; RETAIL EXPOSURES MANAGEABLE

Commercial mortgage loans (CMLs) are a familiar asset class with which the life insurance industry has developed a proven underwriting expertise over a long time frame. The industry's allocation to CMLs and real estate increased to $462 billion representing 11.9% of cash and invested assets at year-end 2016, up from 10.8% at year-end 2013. This reflects a gradual reallocation from corporate bonds to less liquid CMLs. The relatively longer duration of the CML asset class fits well with typical life insurance liabilities which are also typically long-term in nature.

Moody's-rated US life insurers' CML holdings are well diversified by property type. Office and apartment/multifamily property types were the most widely held by the life insurance industry at 26% and 22%, respectively. These were closely followed by retail CMLs at 21.3% at year-end 2016. Retail CML is an area of potential weak performance given the challenges facing the retail industry. Retail industry bankruptcies have increased, and in April, Moody's corporate team lowered its 2017 forecast for US retail operating income growth due primarily to underperformance of companies in five subsectors – specialty retailers, discounters and warehouse clubs, department stores, drug stores

Exhibit 4
CML Holdings broadly Diversified by Property Type
Moody's-rated US Life Insurers' CML by Property Type at Year-End 2016

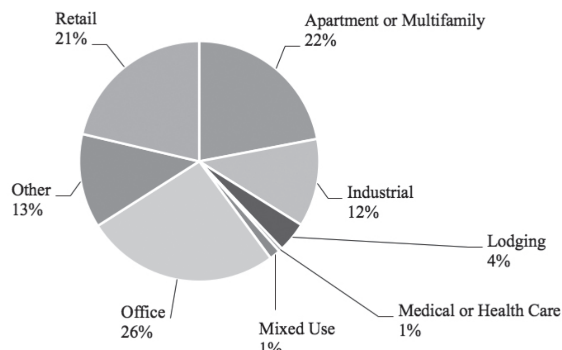


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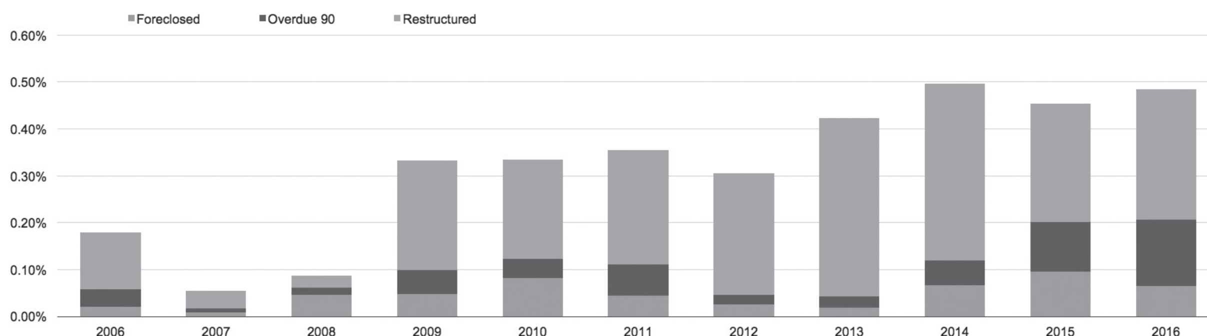
Exhibit 5
Good CML Performance Continues
Moody's-rated Insurers' Non-Performing CMLs by Year

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and office supply. Exhibit 4 below shows Moody's-rated life insurers' CML holdings by property type at year-end 2016.

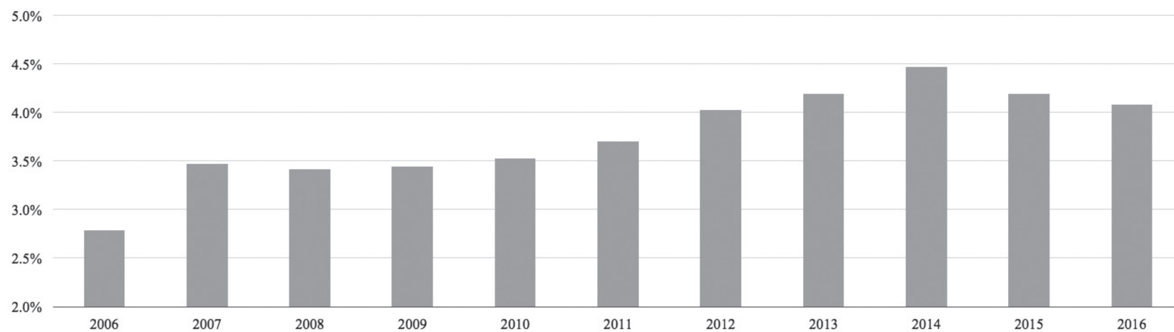
In Moody's view, most of the stress from retail exposure is through Class B and Class C properties, as opposed to the higher-end Class A properties. Insurers also have exposure to this segment though CMBS investments, although frequently insurers own more senior tranches, which mitigates the risk.

US life insurers' CML portfolios have experienced good performance as less than 50bps of CMLs were overdue 90 days, in foreclosure or restructured at year-end 2016. This good performance has been consistent for the past several years. Exhibit 5 below show the industry's troubled CML holdings over time.

## EXPOSURE TO ALTERNATIVE ASSETS DECLINES MODESTLY

US life insurers' allocations to Schedule BA assets – a range of alternatives assets, such as private equity and hedge funds – have moderated to 4.1% at year-end 2016, down from a peak of 4.5% at year-end 2014 as a percentage of cash and invested assets. Exhibit 6 below shows Schedule BA assets for the US life insurance industry as a percentage of cash and invested assets.

Exhibit 6
Recent Decline in Schedule BA Asset Allocation
US Life Insurance Industry Schedule BA Assets as Percentage of Cash & Invested Assets by Year

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Moody's notes that large life insurers (based on invested assets) typically have more highly diversified portfolios, greater investment resources, and broader investment expertise, allowing them to allocate a greater percentage to alternative holdings. For the past five years, as a percentage of cash and invested assets, our 10 largest rated US life insurers have held more than twice the amount of alternatives as the remainder of our rated universe. The size variation is in part attributed to the fact that mutual life insurance companies are some of the largest companies in the industry, and have the ability to allocate more of their investments to higher risk assets because of the long duration and participating policyholder dividend feature associated with a portion of their liabilities.

## HEDGE FUND ALLOCATIONS SET TO DECLINE

Announcements by several life insurers in 2016 indicate that further reductions in alternative investments, primarily hedge funds, are likely to come over the next several years. Insurers' investment income fluctuated in 2016 as a result of poor performance from alternative investments, leading several life insurers to announce plans to reduce their holdings of hedge funds. More recently, in Q1 2017, performance of this asset class rebounded. ■

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